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Establishing Dependant-Care Programs Through Cafeteria Plans: Fulfilling the Need for a Well-Balanced Benefit Menu

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ESTABLISHING DEPENDENT-CARE PROGRAMS THROUGH CAFETERIA PLANS: FULFILLING THE NEED FOR A WELL-BALANCED BENEFIT MENU

I. INTRODUCTION

The taxation of fringe benefits is the subject of much debate and many changes. Cut-backs of currently exempt and deductible benefits are one of the ways the Internal Revenue Service (IRS) is attempting to increase its revenue.[1] While many areas could, and should, be tightened up or eliminated, contemporary social policy indicates that the availability of dependent care as a fringe benefit should be increased.[2]

A "cafeteria plan" is a group of taxable and nontaxable benefits offered by employers from which plan participants, the employees, may choose. The option for employers to offer a variety of benefits via a "cafeteria plan" is an effective and efficient way of increasing dependent-care benefits to those who need them. Cafeteria plans can create effective fringe benefit plans because they allow employees to choose benefits that are suitable to their needs. Salary deductions are efficiently limited because employees deduct from their gross income only the benefits they choose.

The increase of women in the work force today[3] has amplified the demand for dependent care. This change in the makeup of the work force and the resulting changes in the family structure must be recognized. Dependent care deserves a higher position on the list of benefit priorities.

This comment addresses the tax ambiguities concerning "cafeteria" fringe benefit plans that stem from a lack of regulations regard-

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1. "The Tax Reform Act of 1984 is a massive piece of legislation which is part of an attempt to reduce the budget deficit. Tax reform and tax increases, as well as spending cuts, are incorporated in the Act as a means for accomplishing the deficit reduction." Deficit Reduction Act of 1984, Pub. L. No. 369, § 531, 98 Stat. 880, 881-883 (1984) [hereinafter cited as 1984 D.R.A.].

2. *See* Zeitlen & Campbell, *Availability of Child Care for Low-Income Families: Strategies to Address the Impact of the Economic Reconciliation Act of 1981 and the Omnibus Budget Reconciliation Act of 1981,* 16 CLEARINGHOUSE REV. 285 (1982) (discussion of the need for child care and the present unavailability of enough quality day care).

3. Approximately 60% of all women ages 18 to 64 are in the nation's paid work force. WOMEN'S BUREAU, U.S. DEP'T OF LABOR, TWENTY FACTS ON WOMEN WORKERS (1980).

ing these plans. The current lack of enacted regulations has a chilling effect on employers who would establish cafeteria plns.[4] Regulations currently proposed[5] inhibit the effectiveness of these plans and should be revised before they are enacted.[6] The solution is to encourage cafeteria plans and to provide clear, workable regulations which satisfy both the revenue-collecting policy of the IRS, yet provide realistic and practical dependent care programs for employees.

This comment will first discuss the background of tax legislation regarding fringe benefits. Many of these statutes and regulations concerning fringe benefits have not been clearly defined, leaving much of this area vague and subject to changing interpretations.[7] The definition of cafeteria plans, how they work, and how they are currently initiated will also be explained. The specific problems to be addressed are: the lack of established cafeteria plans to provide examples for employers wishing to establish them,[8] the lack of regulations to guide employers wishing to set up a cafeteria plan,[9] and the threat of proposed IRS regulations which, if retroactive in effect, could invalidate existing plans.[10] The proposed regulations and their

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4. *See* Veseley & Wincek, *The Other Shoe Drops: The Proposed Regulations Under Section 125*, 23 TAX NOTES 750 (1984); Lytle, *IRS Proposal May Deter Cafeteria Style Child Care Plans*, REP. ON PRESCHOOL PROGRAMS, Vol. 16, No. 17, Sept. 17, 1984, at 7; Chip, *Current and Quotable, Chip on the Cafeteria Plan Regulations*, 17 TAX NOTES 409 (1982).

5. Treas. Reg. § 1.125-1 (proposed May 7, 1984).

6. If the salary reduction approach does work, the adoption of a [cafeteria] plan could mean substantial tax savings to employees who must pay for child care, with little added cost to employers, particularly as compared to the benefits under the child care credit provisions, which are limited and decrease as income increases. In fact, the employer may actually be able to save money since the benefits provided would not be subject to FICA or FUTA . . . . The only cost to the employer would be administrative; that is, costs necessary to establish the plan (e.g., employee notifications, record-keeping).

Kirschner, *Dependent Care Assistance Programs*, 13 TAX ADVISER 347, 348 (1982).

> [E]mployers have been reluctant to offer the novel plans because of uncertainty over their tax status. That, in turn, led the IRS in May to propose regulations specifically aimed at cafeteria plans. It was apparent at the hearing this summer in Washington D.C., however, that the IRS proposal has not cleared up employer doubts about the plans.

Lytle, *supra* note 4, at 7.

7. *See generally* Cohen, *The Taxation of Fringe Benefits: Alternative Approaches to Current Problems*, 13 SUFFOLK U.L. REV. 1430 (1979).

8. Section 125 cafeteria plans have only been in existence since 1978. I.R.C. § 125 (1985).

9. *See supra* note 4 and accompanying text.

10. The upcoming . . . regulations from Treasury are likely to be retroactive . . . . If the regulations are retroactive, those employers who established reimbursement accounts in 1983 will have to issue new W-2 forms for employ-

current shortcomings will also be discussed.

Overall, these factors have a chilling influence on employers who would establish cafeteria plans that would include the option of dependent care. Therefore, a potential source of employer-provided child care is not being realized.

The proposed solution is to establish comprehensive guidelines regarding dependent care programs which are offered via cafeteria benefit plans and to encourage the availability of these plans.

Establishing workable regulations is the first crucial step to clarify and encourage cafeteria benefit plans. The guidelines must realistically assess the needs of employers and employees for dependent care programs, and the needs of the IRS to maximize the collection of revenue. These policies are not exclusive. The goals of each can be reached by allowing flexibility for plan participants when choosing their benefit needs, and by enacting rules which abolish some of the current problems with these plans.

The availability of cafeteria plans must also be encouraged. The low cost and convenience of employers offering these plans, and the ability of the employee to tailor her own benefit plan, make cafeteria benefit plans an attractive and effective means of providing employees with fringe benefits which are significant terms of employment.[11] Well-structured cafeteria plan regulation will beneficially affect employers and employees, at no cost to the federal government. Dependent care programs, a subset to many cafeteria plan "menus," will be encouraged by such regulations.

> ees, and those employees who have already filed their 1983 tax returns will have to file amended tax returns that include the "reimbursement" amounts in taxable income . . . . [T]he sentiment at Treasury and IRS is "very bloody-minded" because they feel that "benefit banks and ZEBRA's [zero balance reimbursement accounts] are bad, and everyone should have known that.

Klinger, *Flexible Compensation Conference Discusses Cafeteria Plans*, 22 TAX NOTES 1062 (1984).

> I believe that the position which the Treasury and the Internal Revenue Service has taken relative to the "retroactive" impact of its [regulations] on existing plans is bad tax policy and bad public policy especially in view of the inexcusable amount of time which intervened between the 1978 legislation enacting Section 125 and any formal pronouncement from Treasury or the IRS relative to the guidelines under which employers could implement Section 125 plans.

Conable, *Current and Quotable, Conable Explains Cafeteria Plan Proposal to Treasury*, 23 TAX NOTES 1107 (1984).

11. *See* Kirschner, *supra* note 6. *See also* Bankman, *Cafeteria Plans: A Tray of Tax-Free Benefits*, 5 L.A. LAW. 15 (1982-83) (low administrative costs involved in adopting cafeteria plans).

II. Background

A. *Fringe Benefits Legislation*

Gross income is defined by section 61 of the Internal Revenue Code as "all income from whatever source derived, including (but not limited to) [fifteen items listed below]."[12] Items specifically includable in gross income, such as prizes and awards[13] and commodity credit loans,[14] are in part II of Title 26.[15] Items specifically excluded from gross income are found in Part III.[16] Part III consists of sections 101-130, and many of these sections cover current fringe benefits specifically excluded from gross income, including contributions by employers to accident and health plans,[17] scholarships and fellowships,[18] meals and lodging furnished for the convenience of the employer,[19] *cafeteria plans,*[20] and dependent care assistance programs.[21] The tax consequences of fringe benefits are that an employee may deduct from gross income any fringe benefits that qualify for deduction. These include no-additional-cost services,[22]

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12. I.R.C. § 61 (1985). The 15 items listed are:
   (1) Compensation for services, including fees, commissions, and similar items;
   (2) Gross income derived from business;
   (3) Gains derived from dealings in property;
   (4) Interest;
   (5) Rents;
   (6) Royalties;
   (7) Dividends;
   (8) Alimony and separate maintenance payments;
   (9) Annuities;
   (10) Income from life insurance and endowment contracts;
   (11) Pensions;
   (12) Income from discharge of indebtedness;
   (13) Distributive share of partnership gross income;
   (14) Income in respect of a decedent; and
   (15) Income from an interest in an estate or trust.

See Commissioner v. Glenshaw Glass Co., 346 U.S. 426, 432 (1955) (Congress intended term "gross income" to be broadly interpreted).

13. I.R.C. § 74 (1985).
14. I.R.C. § 77 (1985).
15. I.R.C. § 61(b) (1985). Sections 71-100 include items in addition to the 15 listed in § 61(a).
16. I.R.C. §§ 101-130 (1985).
17. I.R.C. § 106 (1985).
18. I.R.C. § 117 (1985).
19. I.R.C. § 119 (1985).
20. I.R.C. § 125 (1985).
21. I.R.C. § 129 (1985).
22. " 'No-Additional-Cost Service Defined.—. . . any service provided by an employer to an employee . . . if—(1) such service is offered for sale to customers . . . and (2) the employer incurs no substantial additional cost . . . in providing such service to the employee. . .

qualified employee discounts,[23] working condition fringes,[24] or *de minimis* fringes.[25] These benefits, and qualified tuition reductions[26] are excluded from an employee's gross income, wage base, and, if applicable, benefit base, for purposes of income tax withholding.[27] For example, if an employee received a salary of $25,000 in 1984, and $1,000 of that represented employer contributions toward an accident plan, the employee's taxable gross income would be $24,000 for 1984.[28]

The IRS, however, does not have sole responsibility for determining which fringe benefits constitute taxable income.[29] Because IRS regulations must be consistent with Treasury Department tax policies, the regulations remain subject to congressional action.[30] The federal courts also have the power to review and interpret administrative rulings, regulations, and laws,[31] including tax regulations.

Judicial and administrative decisions have never held that all economic benefits constitute income.[32] The lenient and sometimes confusing posture of the IRS with regard to fringe benefits is typical of much of modern federal tax history.[33] The taxability of many new

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.'" 1984 D.R.A. sec. 531(a)(1), § 132(b), 98 Stat. 878.

23. "QUALIFIED EMPLOYEE DISCOUNT DEFINED.— . . . any employee discount with respect to qualified property . . . the gross profit percentage of the price at which it is being offered by the employer to customers or . . . services . . . the cost of which does not exceed . . . 20 percent of the price at which the services are being offered by the employer to customers." 1984 D.R.A. sec. 531(a)(1), § 132(c), 98 Stat. 878.

24. "'WORKING CONDITION FRINGE DEFINED.— . . . any property or services provided to an employee . . . to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 [depreciation] or 167 [ordinary and necessary business expense].'" 1984 D.R.A. sec. 531(a)(1), § 132(d), 98 Stat. 879.

25. "'DE MINIMUS FRINGE DEFINED.— . . . any property or service the value of which is . . . so small as to make accounting for it unreasonable or administratively impracticable.'" 1984 D.R.A. sec. 531(a)(1), § 132(e), 98 Stat. 879.

26. "Qualified tuition reduction" . . . means the amount of any reduction in tuition provided to an employee of an [educational] organization for the education ([undergraduate]) at such organization (or another [educational] organization) of (A) such employee, or (B) any person treated as an employee . . . under the rules of section 132(f) [a dependent child or spouse].

1984 D.R.A. sec. 532(a), § 117(d)(2), 98 Stat. 887.

27. 1985 FEDERAL TAX GUIDE REPORTS (CCH) ¶ 1999.

28. *See* I.R.C. § 106 (1985) (gross income does not include contributions by the employer to accident or health plans for compensation to employees for personal injuries or sickness).

29. Cohen, *supra* note 7, at 1439.

30. 1 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, FEDERAL INCOME TAXATION (6th ed. 1972).

31. Cohen, *supra* note 7, at 1439.

32. Burke & Friel, *Recent Developments in the Income Taxation of Individuals*, 8 REV. TAX'N INDIV. 163 (1984).

33. Early Treasury rulings held that:

[S]upper money paid by an employer to an employee performing extra labor benefit packages was virtually unchallenged by the Treasury and the IRS, and as a result taxpayers began to assume that fringe benefits were not taxable at all.[34] It was discovered, however, that "[t]he Treasury's nonaggressive approach to the taxation of nonstatutory fringe benefits proved to be inappropriate as a matter of tax policy."[35] The receipt of fringe benefits rather than cash compensation both reduced the federal tax base and created inequity among taxpayers.[36] In spite of numerous attempts to clarify fringe benefit legislation,[37] this confusion continues to exist.

No general standard has been developed to determine the taxation of fringe benefits. Some fringe benefits are carefully examined and categorized to determine tax consequences,[38] while other items have been traditionally excluded. No explicit, comprehensive legislative explanation for exclusion of these varied benefits exists.[39] The concepts behind taxability of certain benefits are not uniformly applied with respect to similar fringe benefits.[40] The need to clarify fringe benefits legislation is obvious, and though many attempts have been made,[41] none have been satisfactory.

B. *Cafeteria Plans*

1. *Description*

Into this area of uncertainty and ambiguity cafeteria plans were introduced. As their name suggests, the unique feature of a cafeteria

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> after regular hours is considered paid for the convenience of the employer and for that reason does not represent income to that employee. A year later, the Treasury ruled that "personal transportation passes issued by a railroad company to its employees and their families . . . are considered gifts and the value does not constitute taxable income to the employees."

Id. at 163, nn.3-4 and accompanying text.

34. *Id.*

35. Burke & Friel, *supra* note 32, at 164.

36. "[A] taxpayer receiving no fringe benefits and $21,000 in cash compensation would pay more tax than a similarly situated taxpayer who received $20,000 in cash compensation and $1,000 in fringe benefits." *Id.*

37. *See infra* note 41 and accompanying text.

38. For example, for meals to be excluded from an employee's gross income, a two-part test must be met: "(i) The meals [must be] furnished on the business premises of the employer, and (ii) the meals are furnished for the convenience of the employer." Treas. Reg. § 1.119-1(a)(1) (1984). To exclude lodging, a third element is added to the meals test: "[T]he employee is required to accept such lodging as a condition of his [or her] employment." Treas. Reg. § 1.119-1(b)(3) (1984).

39. Cohen, *supra* note 7, at 1441.

40. *Id.* at 1445.

41. *See generally* Burke & Friel, *supra* note 32 (discussion of the attempts at drafting comprehensive fringe benefit legislation beginning in September 1975).

plan is that employers provide a choice of benefits for their employees. The "menu" offers employees their choice of cash or fringe benefits that are excludable from gross income.[42] From the menu, employees select the benefits they prefer, rather than participating in an overall plan that is not intended to meet their individual needs.[43] For example, an employee with children may choose dependent care as a benefit rather than dental care or extensive life insurance coverage.

Cafeteria plans are discussed and defined in section 125 of the IRC.[44] The plan is generally defined as, "a written plan under which—(A) all participants are employees, and (B) the participants may choose among two or more benefits. The benefits which may be chosen may be nontaxable benefits, cash, property, or other taxable benefits."[45] Further definition is provided in the proposed regulations.[46] Benefits offered to participants may include taxable benefits[47] or nontaxable benefits.[48] A cafeteria plan may also offer benefits that are nontaxable because they are attributable to after-tax employee contributions.[49] Cafeteria plans currently require election of prospec-

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42. I.R.C. § 125(d)(1) (1985).

43. *Cf.* The indiscriminate and uncoordinated use of fringe benefit plans can result in unnecessary expenses and a dissatisfied client. A fringe benefit plan should never be installed until a careful analysis is made of employer and employee needs . . . . Tax consequences must not be considered only in general terms but applied to ***this particular employer and employee.***

E. STOEBER, TAX AND FRINGE BENEFIT PLANNING FOR PROFESSIONAL CORPORATIONS (3d ed. 1977) (emphasis in original).

44. I.R.C. § 125 (1985).

45. I.R.C. § 125(d)(1) (1985).

46. Treas. Reg. § 1.125-1 (proposed May 7, 1984).

47. "The term taxable benefit means cash, property, or other benefits attributable to employer contributions that are currently taxable to the participant under the Internal Revenue Code upon receipt by the participant." Treas. Reg. § 1.125-1 (1984), 49 Fed. Reg. 19,322, at A-5 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984).

48. The term "nontaxable benefit" means any benefit attributable to employer contributions to the extent that such benefit is not currently taxable to the participant under the Internal Revenue Code upon receipt of the benefit . . . . [T]he following benefits . . . will be nontaxable when provided in accordance with the applicable provisions of the Internal Revenue Code: group-term life insurance up to $50,000, . . . coverage under an accident or health plan, . . . coverage under a qualified group legal services plan, . . . and coverage under a dependent care assistance program . . . . Also, amounts received by participants under one of these benefits may or may not be taxable depending upon whether such amounts qualify for an exclusion from gross income.

Id.

49. For example, a cafeteria plan may offer participants the opportunity to purchase, with after-tax employee contributions, coverage under an accident or health plan providing for payment of disability benefits. A participant's receipt of coverage under such an accident or health plan would not trigger taxable income because the coverage would be purchased with after-tax employee con-

tive benefits. Benefits offered under a cafeteria plan must not be revokable. Any revokable benefits are considered "currently available"[50] and are not allowed as part of a cafeteria plan. A benefit is considered currently available when there is no restriction or limitation upon the receipt of the benefits.[51]

The definition of a "cafeteria plan" which states that: "[t]he benefits which may be chosen may be nontaxable benefits, or cash, property, or other nontaxable benefits,"[52] was commonly interpreted to allow employees a choice of nontaxable cash.[53] This allowance is, however, contrary to the revenue collecting goals of the IRS. Many employers set up cafeteria plans as reimbursement plans.[54] Under a reimbursement plan, an employee submits proof of her dependent care and other expenses to her employer. The employer then allocates a portion of the employee's salary as "reimbursement." "The employee treats that part of [her] salary as a tax-free payment, just as [she] would a corporate expense account."[55] The IRS recognized a potential loss of revenue, and proposed regulations for cafeteria plans that minimize tax-free reimbursements.[56] The IRS maintains that reimbursement payments are part of the employee's wages and that "the employer neither bears the cost, nor assumes the risk, of that

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> tributions. Similarly, any amounts paid to a participant under such an accident or health plan on account of disability incurred during the year of coverage may be nontaxable under section 104(a)(3) [(amounts received through accident or health insurance)].

Id.

50. > A benefit is treated as currently available to a participant if the participant is free to receive the benefit currently at his discretion or the participant could receive the benefit currently if an election or notice of an intent to receive the benefit were given. A benefit will not be treated as not currently available merely because of a requirement that the participant must elect or give notice of intent to receive the benefit in advance of receipt of the benefit.

Treas. Reg. § 1.125-1 (1984), 49 Fed. Reg. 19,322, at A-14 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984).

51. > [A] benefit is not currently available to a participant if there is a substantial limitation or restriction on the participant's receipt of the benefit. A benefit will not be treated as currently available if the participant may under no circumstances receive the benefit before a particular time in the future and there is a substantial risk that, if the participant does not fulfill specified conditions during the period preceding this time, the participant will not receive the benefit.

Id.

52. Sheppard, *Zebras On The Loose In The All-You-Can-Eat Cafeteria*, 23 TAX NOTES 565, 566 (1984).

53. *Id.*

54. *Id.*

55. *Id.* at 565.

56. Treas. Reg. § 1.125-1 (proposed May 7, 1984).

amount or existence of employee expenses."[57]

Section 125 also requires that a plan not discriminate in favor of highly compensated participants[58] as to their eligibility to participate or as to contributions and benefits.[59] Section 129 sets discrimination standards for dependent care assistance programs.[60] The employer may set up a nondiscriminatory classification of employees to be benefitted,[61] and not more than twenty-five percent of the dependent care benefits may be provided for principal shareholders or owners.[62]

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57. Sheppard, *supra* note 52, at 565.

58. The term "highly compensated participant" means a participant who is —

> (A) an officer
>
> (B) a shareholder owning more than 5 percent of the voting power or value of all classes of stock of the employer,
>
> (C) highly compensated, or
>
> (D) a spouse or dependent (within the meaning of section 152) of an individual described in paragraph (A), (B), or (C). . . . The term "highly compensated individual" means an individual who is described in subparagraphs (A), (B), (C), or (D) of paragraph (1) [above].

I.R.C. § 125(e) (1985).

59. I.R.C. 125(b)(1)(A), (B) (1985). However, there are some employees exempted from this discrimination standard:

> For purposes of subparagraph (A) of subsection (b)(1) [defining highly compensated participants and individuals], a classification shall not be treated as discriminatory if the plan —
>
> (A) benefits a group of employees [who are beneficiaries under a trust], and
>
> (B) meets the requirements of clauses (i) and (ii):
>
> (i) No employee is required to complete more than 3 years of employment with the employer or employers maintaining the plan as a condition of participation in the plan, and the employment requirement for each employee is the same.
>
> (ii) Any employee who has satisfied the employment requirement of clause (i) and who is otherwise entitled to participate in the plan commences participation no later than the first day of the first plan year beginning after the date the employment requirement was satisfied unless the employee was separated from service before the first day of that plan year.

I.R.C. § 125(g)(3) (1985).

60. "The contributions or benefits provided under the plan shall not discriminate in favor of employees who are officers, owners, or highly compensated, or their dependents." I.R.C. § 129(d)(2) (1985).

61.
> The program shall benefit employees who qualifty under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of employees described in paragraph (2), or their dependents. For purposes of this paragraph, there shall be excluded from consideration employees not included in the program who are included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that dependent care benefits were the subject of good faith bargaining between such employee representatives and such employer or employees.

I.R.C. § 129(d)(3) (1985).

62. Not more than 25% of the amounts paid or incurred by the employer for

Presently, the actual written cafeteria plan may not discriminate in favor of highly compensated or key employees regarding selected benefits; the language of the section does not refer to "offered" benefits.[63]

2. *Establishing a Cafeteria Plan*

Employers wishing to establish a dependent care program via a cafeteria plan must not only comply with section 125, but also with the proposed regulations,[64] and section 129,[65] which covers dependent care assistance programs.[66] The requirements of section 125 are straightforward. They require cafeteria plans to be in writing, that all participants are employees, and that participants choose among two or more taxable or nontaxable benefits.[67] Deferred compensation plans are not allowed,[68] and the plan may not discriminate in favor of highly compensated participants.[69] The proposed regulations set strict rules requiring prospective election of benefits[70] and strict discrimination standards.[71]

Presently, if an employer wishes to establish a cafeteria plan, a benefits consultant may be employed to help develop a plan that complies with current rules and regulations and meets the needs of the employees. Employers must propose a written plan that summarizes the plan description and discusses how the plan works. Election forms for employees to choose among the offered benefits must also be provided. An employer must then modify the company payroll system to accompany the salary deductions.[72] An employee's

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> dependent care assistance during the year may be provided for the class of individuals who are shareholders or owners (or their spouses or dependents), each of whom (on any day of the year) owns more than 5% of the stock or of the capital or profits interest in the employer.

I.R.C. § 129(d)(4) (1985).

63. Treas. Reg. § 1.125-1 (1984), 49 Fed. Reg. 19,322, at A-11 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984).

64. Tres. Reg. § 1.125-1, at A-5 (proposed May 7, 1984).

65. I.R.C. § 129 (1985).

66. Note: all benefits offered under a cafeteria plan must satisfy the requirements of their relevant code sections.

67. I.R.C. § 125(d)(1) (1985) (cafeteria plans in general), and § 125(f) (1985) (nontaxable benefit defined).

68. I.R.C. § 125(d)(2) (1985) (deferred compensation plans excluded).

69. I.R.C. § 125(e) (1985) (definition of highly compensated participant and individual), and § 125(g)(3) (1985) (certain participation eligibility rules not treated as discriminatory).

70. Treas. Reg. § 1.125-1 (1984), 49 Fed. Reg. 19,322, at A-8, A-15 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984).

71. Treas. Reg. § 1.125-1, at A-19 (proposed May 7, 1984).

72. According to William W. Chip of Ivins, Phillips & Barker in Washington D.C.,

paycheck will reflect the chosen deductions. Employers offering cafeteria plans must file tax returns that show how many employees are in the company, how many employees are participating in the plan, the total cost of the plan, the type of business the employer is in, and any information requested by the Secretary of the Treasury.[73]

Employers attempting to establish cafeteria plans experience difficulty because there are presently no enacted regulations regarding these types of benefit plans.[74] The only guidelines available are section 125 itself and the recently proposed regulations. Because the existing information on cafeteria plans is limited, employers have set up their plans with little guidance. This has resulted in cafeteria plans which allow participants to submit proof of their medical expenses or dependent care costs to their employer who then allows a portion of their salary to "reimburse" them for the expenses.[75]

Through cafeteria plans, employers pay only for benefits elected by their employees. Employers thus save the expense of offering benefits employees do not desire.[76] Employees can maximize the effectiveness of their benefit plan by choosing those benefits that meet their needs. Salary reduction results only from benefits the employee has chosen.

The inexactitude of employers in establishing cafeteria plans in the past justifies strict "policing" of these plans today. This "policing," however, must not discourage the use of cafeteria plans, and thus reduce an option for dependent care benefits.

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deciding which benefits to offer is the most difficult part of establishing a cafeteria plan. Most employers use an Employee Benefits Consultant to help them to decide which benefits are best able to meet the needs of their employees. Telephone conversation with William Chip (Jan. 7, 1985).

73. "Any employer who . . . maintains a cafeteria plan . . . and . . . is required by the Secretary to file an additional return . . . shall file such additional return." 1984 D.R.A. sec. 531(b)(4)(A), § 125(h)(3), 98 Stat. 882.

74. Section 125 was enacted by the Revenue Act of 1978. In 1982, William W. Chip wrote a letter to Treasury Assistant Secretary for Tax Policy John E. Chapoton calling for regulations to remove the risks of establishing cafeteria plans. *See* Chip, *Current and Quotable, Chip on the Cafeteria Plan Regulations*, 17 TAX NOTES 489 (1982).

75. For the first few years after enactment, very few cafeteria plans were set up, and these were plain vanilla plans. In 1982, the reimbursement type cafeteria plans began to appear as practitioners took advantage of the drafting mistake and the lack of guidance from the IRS. The IRS did not get wind of ZEBRAS [zero-balance reimbursement accounts] until recently . . . .

Sheppard, *supra* note 52, at 565. "The employee treats that part of his [or her] salary as a tax-free payment, just as he [or she] would a corporate expense account." *Id.*

76. Telephone conversation with William Chip, *supra* note 72.

C. *The Proposed Regulations*

The means chosen to "police" cafeteria plans are the establishment of Treasury regulations that describe IRS policy regarding the plans. To date, no regulations have been enacted. In May 1984, the IRS proposed regulations regarding cafeteria plans.[77]

The proposed regulations require the plan to offer at least one taxable and one nontaxable benefit. They also explain what the written cafeteria document must contain, what benefits may be offered, and how to set up a plan that does not discriminate in favor of highly compensated participants.[78] The regulations require the plan to be contained in a separate, written document.[79]

The proposed regulations also establish rigid requirements regarding when employees must choose their benefits, and the quantity of those benefits. The proposed regulations do not set up cafeteria plans as effectively and efficiently as they could. The rigidity of the regulations makes cafeteria plans less able to accommodate the bene-

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77. The likelihood of the regulations passing is difficult to predict. Section 125 was passed in 1978 and it was not until May 1984 that the proposed regulations were published. The tax bill passed by Congress in June of 1984 elaborated on the proposed cafeteria plan regulations in some areas. The IRS is still considering whether to issue final regulations and, if so, what they will contain.

78. [I]n order to be treated as nondiscriminatory for a plan year, a cafeteria plan must not discriminate in favor of highly compensated participants as to benefits and contributions for that plan year. Generally, this discrimination determination will be made on the basis of the facts and circumstances of each case. Section 125(c) provides that a cafeteria plan does not discriminate where either (i) total nontaxable benefits and total benefits or (ii) employer contributions allocable to total nontaxable benefits and employer contributions allocable to total benefits do not discriminate in favor of highly compensated participants. A cafeteria plan must satisfy section 125(c) with respect to both benefit availability and benefit selection. Thus, a plan must give each participant an equal opportunity to select nontaxable benefits, and the actual selection of nontaxable benefits under the plan must not be discriminatory. . . .

> [A] cafeteria plan must not discriminate in favor of highly compensated participants in actual operation. A plan may be discriminatory in actual operation if the duration of the plan (or of a particular nontaxable benefit offered under the plan) coincides with the period during which highly compensated participants utilize the plan (or the benefit).

Treas. Reg. § 1.125-1 (1984), 49 Fed. Reg. 19,322 at A-19 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984).

79. A "cafeteria plan" is a separate written benefit plan maintained by an employer for the benefit of its employees, under which all participants are employees and each participant has the opportunity to select the particular benefits that he [or she] desires. A cafeteria plan may offer participants the opportunity to select among various taxable . . . and nontaxable benefits, but a plan must offer at least one taxable . . . and one nontaxable benefit.

Tres. Reg. § 1.125, at A-2 (proposed May 7, 1984).

fit requirements for unpredictable needs such as dependent care.

The proposed regulations establish inflexible requirements regarding when employees must choose their benefits, and the quantity of those benefits. Currently, an employee may submit the exact cost of incurred benefit expenses to his or her employer and be reimbursed for the cost.[80] The proposed regulations, however, require that prospective predictions of benefit needs be made a full year in advance.[81] The need for a benefit such as child care or dependent care is not easy to predict over the course of a year.

Generally, revocation of elected benefits is not allowed in cafeteria plans under the proposed regulations.[82] Currently, revocations or changes in benefits may be made only if there is a change in family status.[83] No other changes of circumstances will justify a change in benefits previously elected. Particularly in the dependent care area, yearly needs may vary significantly due to unplanned events. Sudden

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80. *See supra* note 55 and accompanying text.

81. [A] cafeteria plan should require participants to elect the specific benefits that they will receive before the taxable benefits become currently available. A benefit will not be treated as currently available as of the time of the election if the election specifies the future period for which the benefit will be provided and the election is made before the beginning of this period.

> For example, assume that a cafeteria plan offers each participant the opportunity to elect, *for the plan year*, between coverage under a dependent care assistance program for up to $2,000 of the dependent care expenses incurred by the participant during the plan year or a cash benefit of $2,000 for the year. If the plan requires participants to elect between these benefits before the beginning of the plan year and, after the year has commenced, the participants are prohibited from revoking their elections, participants who elected coverage under the dependent care assistance program will not be taxed on the cash benefit of $2,000.

Treas. Reg. § 1.125-1 (1984), 49 Fed. Reg. 19,322, at A-15 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984) (emphasis added).

82. An election will not be deemed to have been made if, after a participant has elected and begun to receive a benefit under the plan, the participant is permitted to revoke the election, even if the revocation relates only to that portion of the benefit that has not yet been provided to the participant.

> For example, a plan that permits a participant to revoke his [or her] election of coverage under a dependent care assistance program or of coverage under an accident or health plan after the period of coverage has commenced will not be a cafeteria plan.

Tres. Reg. § 1.125-1, at A-8 (proposed May 7, 1984).

83. [A] cafeteria plan may permit a participant to revoke a benefit election after the period of coverage has commenced and to make a new election with respect to the remainder of the period of coverage if both the revocation and new election are on account of and consistent with a change in family status (e.g., marriage, divorce, death of spouse or child, birth or adoption of child, and termination of employment of spouse).

Id.

illnesses, injuries, and even job opportunities are unpredictable, especially over the course of a twelve-month plan.

Benefits selected at the beginning of the plan year which are not used by the employee during the year must be forfeited under the currently proposed regulations.[84] This has been referred to as the "use-it-or-lose-it" rule.[85] It has been suggested that the IRS allow employees to "rollover" their unused nontaxable benefits.[86] Rollovers would allow employees to carry forward any unused nontaxable benefits to the following plan year, provided they did not exceed their maximum benefit allowance.[87]

This difficulty in prediction, combined with the fear of losing money set aside for unused benefits,[88] will encourage employees to underestimate their needs for dependent care. Underestimation of need will often cause inadequate coverage for dependent care costs. Because an employee, under these proposed regulations, must predict benefits one year in advance, the employee is prohibited from obtaining adequate coverage upon the discovery that more is needed.

The proposed Treasury regulations also require cafeteria plans to satisfy the discrimination rules in section 125(c)[89] with regard to benefit availability and benefit selection:[90] "In addition to not discriminating as to either benefit availability or . . . selection, a cafeteria plan must not discriminate . . . in actual operation."[91] The pur-

84. Sheppard, *supra* note 52, at 565.

85. *Id.*

86. *Conable Proposes Cafeteria Plan Rules*, 23 TAX NOTES 567, 568 [hereinafter cited as *Conable Proposes*]; Letter from Sally Goldfarb and Nancy Duff Campbell of the National Women's Law Center to Roscoe L. Egger, Jr., Commissioner of Internal Revenue (July 6, 1984) (submitting comments in response to the proposed IRS regulations on tax treatment of cafeteria plans).

87. *Conable Proposes*, *supra*, note 86.

88. Sheppard, *supra* note 52, at 565 ("IR-84-22 makes it clear that if you don't spend the money, you lose it, just like any other insurance policy . . . .") (statement of Mary Henever, attorney in the Office of Tax Legislative Counsel).

89. "For purpose of [highly compensated participants as to contributions and benefits], a cafeteria plan does not discriminate where statutory nontaxable benefits and total benefits (or employer contributions allocable to statutory nontaxable benefits and employer contributions for total benefits) do not discriminate in favor of highly compensated participants." I.R.C. § 125(c) (1985).

90. "Thus a plan must give each participant an equal opportunity to select nontaxable benefits, and the actual selection of nontaxable benefits under the plan must not be discriminatory, i.e., highly compensated participants do not disproportionately select nontaxable benefits while other participants select taxable benefits." Treas. Reg. § 1.125-1 (1984), 49 Fed. Reg. 19,322, at A-19 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984).

91. *Id.* "A plan may be discriminatory in actual operation if the duration of the plan (or of a particular benefit offered under the plan) coincides with the period during which highly compensated participants utilize the plan (or the benefit)." *Id.*

pose of these restrictions is to prevent corporations from taking a tax deduction for benefits offered only to owners and principal shareholders.[92] This comment suggests other methods of safeguarding against the discrimination problem, while still allowing flexible cafeteria plans.

The result of these proposed regulations is that employers who are aware of the uncertainties are hesitant to adopt cafeteria plans.[93] This uncertainty has had a negative effect on increasing employer-provided dependent care programs[94] and this negative effect is likely to continue without more definitive guidelines. There is also some debate as to whether or not the proposed regulations, if passed, will be retroactively effective.[95] If they are retroactive, all plans which currently allow tax-free reimbursements for benefit expenses already incurred will be invalidated.[96] Although some employers may feel that these regulations have set down rules, thereby making it "safe" to establish cafeteria plans within those rules,[97] the effectiveness of cafeteria plans is diminished.[98]

D. *Dependent-Care Programs*

Dependent-care assistance programs are governed by Internal Revenue Code section 129. This section defines a dependent care assistance program as "a separate written plan of an employer for the exclusive benefit of his employees to provide such employees with dependent care assistance . . . ."[99] Dependent care benefits may not favor officers, owners, or highly compensated employees, or their de-

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92. *See* Larkin v. Commissioner, 48 T.C. 629 (1967) (medical reimbursement payments made by a corporation to its stockholder-officer-employees did not constitute a "plan for employees" deductible by the corporation for income tax purposes). Edward and Mary Smithback, 1969 T.C.M. (P-H) 760. ¶ 61,135 (1969) (payments from the corporation for medical expenses of the owner and his family not excludable; medical plan's purpose was to benefit the owner as the owner, not an employee).

93. *See supra* note 4 and accompanying text.

94. *See supra* note 2 and accompanying text.

95. *See supra* note 10, (discussion of retroactivity), *see also* introductory comments preceding Treas. Reg. § 1.125-1 (1984), 49 Fed. Reg. 19,322 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984) ("*If* final regulations are more restrictive than the guidance in this Notice, the regulations will not be applied retroactively.") (emphasis added).

96. *See supra* note 10.

97. Telephone conversation with William Chip, *supra* note 72.

98. Letter from Sally Goldfarb and Nancy Duff Campbell of the National Women's Law Center to Roscoe L. Egger, Jr., Commissioner of Internal Revenue (July 6, 1984) (submitting comments in response to the proposed IRS regulations on tax treatment of cafeteria plans).

99. I.R.C. § 129(d)(1) (1985).

pendents.[100] The employer must provide reasonable notification of the availability and terms of the program to eligible employees.[101] "The plan shall furnish to an employee . . . a written statement showing the amounts paid or expenses incurred by the employer in providing dependent care assistance to such employee during the previous . . . year."[102]

Section 129 (e) (1) incorporates section 21 (b) (2), relating to expenses for household and dependent care services necessary for gainful employment.[103] "Qualifying individuals," for whose care tax credits are available,[104] include:

> (A) a dependent of the taxpayer who is under the age of 15 and with respect to whom the taxpayer is entitled to a deduction under section 151 (e).[105]
> (B) a dependent of the taxpayer who is physically or mentally incapable of caring for himself [or herself], or
> (C) the spouse of the taxpayer, if he [or she] is physically or mentally incapable of caring for himself [or herself].[106]

Under this section, and section 152 (which provides a definition of a dependent),[107] dependent care is a broader concept than child care.

100. I.R.C. § 129(d)(2) (1985). If there is a group of employees who have bargained collectively for dependent care benefits they may be excluded from consideration when examining the plan for the purposes of finding discrimination. *Id.* at § 129(d)(3).

101. *See supra* note 99, at § 129 (d)(6).

102. *Id.* at § 129(d)(7).

103. "The term 'dependent care assistance' means the payment of, or provision of, those services which if paid for by the employee would be considered employment-related expenses under section 21(b)(2) (relating to expenses for household and dependent care services necessary for gainful employment.)" I.R.C. § 129(e)(1) (1985).

104. In the case of an individual who maintains a household which includes as a member one or more qualifying individuals (as defined in subsection (b)(1)), [cited *infra* at note 106] there shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to the applicable percentage of the employment-related expenses (as defined in subsection (b)(2) *infra* at note 108) paid by such individual during the taxable year. I.R.C. § 21(a)(1) (1985).

105. I. R.C. § 151(e) (1985) allows an additional $1,000 exemption for a dependent, as described in § 152.

106. I.R.C. § 21(b)(1) (1985).

107. [T]he term "dependent" means any of the following individuals over half of whose support . . . was received from the taxpayer . . .:

(1) A son or daughter of the taxpayer, or a descendant of either,
(2) A stepson or stepdaughter of the taxpayer,
(3) A brother, sister, stepbrother, or stepsister of the taxpayer,
(4) The father or mother of the taxpayer, or an ancestor of either,
(5) A stepfather or stepmother of the taxpayer,
(6) A [nephew or niece] of the taxpayer,
(7) A[n] [uncle or aunt] of the taxpayer,
(8) A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-

The cost of caring for any dependent of the taxpayer, including parents and other relatives, may be covered under a cafeteria plan, provided the "expenses are incurred [for the purpose of allowing] the taxpayer to be gainfully employed . . . ."[108]

It is not necessary for an employer offering dependent care assistance under a cafeteria plan to provide dependent care on the business premises. An employee participating in the dependent care option may choose her own facilities. She will be reimbursed for her dependent care costs if the caretaker satisfies certain requirements. For example, payments for dependent care to relatives of the taxpayer for whom a deduction is allowed are not excludable from gross income under section 129.[109] These payments are also ineligible for a tax credit under section 21.[110] Employment-related expenses paid to a dependent care center[111] are allowed credit under section 21.

III. PROBLEM

A primary cause of the uncertainty and ineffectiveness of cafeteria plans is the lack of enacted regulations providing established rules that work, for employers and employees as well as the IRS. The lack of regulations has led employers to set up liberal cafeteria plans.[112] The problem of lost revenue concerning cafeteria plans "is

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in-law, or sister-in-law of the taxpayer, or

(9) An individual (other than an individual who at any time during the taxable year was the spouse, determined without regard to section 143 [determination of marital status], of the taxpayer) who, . . . has as his [or her] principal place of abode the home of the taxpayer and is a member of the taxpayer's household.

I.R.C. § 152(a) (1985).

108. I.R.C. § 21(b)(2)(A) (1985).

109. No amount paid or incurred during the taxable year of an employee by an employer in providing dependent care assistance to such employee shall be excluded under subsection (a) if such amount was paid or incurred to an individual—

(1) with respect to whom . . . a deduction is allowable under section 151(e) (relating to personal exemptions for dependents) to such employee or the spouse of such employee, or

(2) who is a child of such employee . . . under the age of 19 at the close of such taxable year.

I.R.C. § 129(c) (1985).

110. I.R.C. § 21 (1985) is a provision to § 129(c), *see supra* note 109, which disallows tax credit for any money paid to a related individual as described in § 129 (c).

111. "[T]he term 'dependent care center' means any facility which— (i) provides care for more than six individuals (other than individuals who reside at the facility), and (ii) receives a fee, payment, or grant for providing services for any of the individuals (regardless of whether such facility is operated for profit)." I.R.C. § 21(b)(2)(D) (1985).

112. *See supra* text accompanying notes 6, 10 & 111.

a simple matter of sloppy drafting,"[113] coupled with a lack of regulations. However, IRS Commissioner Roscoe L. Egger, Jr. pointed out that "Since when does a lack of regulations confer carte blanche? . . . IRS scrutiny of plans is a normal fact."[114] It has been predicted that:

> Widespread cheating can be expected if cash reimbursements are excluded from tax[es], . . . The employer . . . has little reason to question the amounts of the employees' claims because the former's total outlay is the same in either case. In the case of the employer-provided insurance, the same is true, but the employer is assured that the amount spent on the premium will be used for its intended purpose . . . .[115]

Liberal cafeteria plans have prompted the IRS to propose very rigid regulations which inhibit the expansion and availability of cafeteria plans.[116] Guidelines must be enacted that will further both the IRS policy of collecting revenue, and the creations of efficient and practical plans from the perspective of the employers and plan participants.

IV. Legal Analysis/Proposal

The suggested changes which follow constitute improvements which should be made to cafeteria fringe benefit plans to make them more practical and efficient. Part A proposes the continued disallowance of rollover and reimbursements of unused benefits.[117] Part B recommends shorter plan years regarding election of dependent care benefits. This comment suggests that four or six-month dependent care plans be established instead of the twelve-month calendar year in the proposed Treasury regulations. In addition, the plans should allow for revocation or alterations of dependent care upon a showing of changed circumstances. The discrimination rules suggested in Part

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113. *See* Sheppard, *supra* note 52.

114. Sheppard, *supra* note 52, at 565.

115. *Id.* at 566.

116. Adding to the confusion is the possibility of legislation which would repeal cafeteria plans altogether. *Id.*

According to William Chip, *supra* note 72, there is currently some tax legislation being offered that may eliminate cafeteria plans altogether. While this discussion is beyond the scope of this comment, the existence of cafeteria plans must be encouraged. The proposals in this comment should make cafeteria plans more acceptable to the IRS, thus securing the future of these plans.

117. These suggestions are not changes per se; rollovers and reimbursements are currently not allowed by the IRS. This comment agrees with the reasoning behind that decision. The changes suggested in this comment make up for the harshness of this rule by allowing more flexibility within cafeteria plans themselves.

C are thus more effective than those currently codified in sections 125 and 129 and those contained in the proposed Treasury regulations. While currently the actual written cafeteria plan may not discriminate in favor of highly compensated or key employees, the test to determine if a plan is discriminatory should apply only to benefits *offered*, and not to the benefits *selected* by the plan participants.

A. *Elimination of Rollovers and Reimbursements*

Reimbursements[118] allow cafeteria plan participants to be reimbursed for benefit expenses already incurred by the participant.[119] Rollovers refer to the cash value of an employee's unused benefits that he or she would be allowed to carry over, or "rollover," to the next plan year.[120] Reimbursements should be discontinued and rollovers should not be allowed. The IRS is opposed to these methods[121] due to their negative effect on revenue collecting.[122] Rollovers and reimbursements are unnecessary means toward the goal of efficiency. Cafeteria plans without rollover and reimbursement features remain excellent methods of employer-sponsored dependent care.

Two of the following provisions eliminate the need for rollovers and reimbursements: 1) allowing shorter plan years, and 2) allowing plan revisions for more changes of circumstances than currently allowed in the proposed Treasury regulations. These two proposals eliminate the need for rollover and reimbursement because they al-

118. *See supra* text accompanying note 6.

119. "[T]he employee submits proof of his [or her] medical, legal, dependent care or other expenses to his [or her] employer, who then recharacterizes a portion of the employee's salary as 'reimbursement'." Sheppard *supra* note 52, at 565.

120. House Ways and Means Committee ranking minority member Barber A. Conable, Jr. . . . has proposed a plan to place restrictions on cafeteria fringe benefit plans . . . .

> Under the proposal, a plan could qualify as a cafeteria plan only if a specified amount was committed to the employee's account as of the beginning of the plan year, and the employees were required on or before the beginning of the plan year to irrevocably choose which portion of the total amount is allocated to taxable or nontaxable benefits. Employees would not be permitted to cash out unused nontaxable benefits later in the year. However, employees could carry forward the unused nontaxable benefit to the next plan year, subject to the overall cap on flexible benefits, which could not be moved upward.

Conable Proposes, *supra* note 86, at 567.

121. Veseley, *supra* note 4, at 750; Conable Proposes, *supra* note 86, at 567; Sheppard *supra* note 52, at 565.

122. "Mary B. Henever, an attorney in the Office of Tax Legislative Counsel . . . noted that the cost to the federal fisc of zero-based reimbursement accounts (ZEBRAs), flexible spending plans and other reimbursement-type cafeteria plans would be $16 billion by 1989 if the government allowed them to continue." Sheppard, *supra* note 52, at 565.

low employees to make more predictable estimates of their needs. They also recognize additional changes of circumstance which legitimate benefit plan changes.

B. *Election of Benefits*

1. *Implementation of Shorter Plan Years*

The proposed Treasury regulations currently require a cafeteria plan year to be of a twelve-month duration.[123] The terms of the plan must permit contributions to the plan, and receipt of the benefits only once during a plan year.[124] In light of the present restrictions on rollovers and reimbursements,[125] longer plan years increase the risk of an employee underestimating her benefit needs because of fear of losing money allocated to unused benefits. A shorter plan year would require employees to take fewer risks in estimating their benefit needs, and thus would reduce the harshness of disallowing rollovers and reimbursements.

Allowing employees to implement a new plan, or to reduce or eliminate an existing plan more often than once a year, will let them make more accurate decisions. This change would also be a more efficient means of revenue collection. Allowing an employee to reduce dependent-care benefits without penalty once they are no longer needed will cause employees to reduce their amount of unused benefits. This reduction of benefits will increase the amount of taxable income, thus increasing IRS revenue.

Shorter plan years and increased opportunities to adjust dependent-care benefits could be established in one of two ways. Dependent-care benefits provided under a cafeteria plan should be made in four-month or six-month plans, rather than the twelve-month plan years proposed in the Treasury regulations. Employees would re-

123. Letter from Sally Goldfarb and Nancy Duff Campbell of the Nat'l Women's Law Center to Interested Advocacy Groups and Individuals (July 13, 1984) (regarding comments and testimony on employer cafeteria plans). *See generally* Treas. Reg. § 1.125-1 (1984), 49 Fed. Reg. 19,322, at A-7, A-18, A-21 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984). Although it is not actually spelled out in terms of months, when length of time is mentioned in the proposed Treasury regulations, it is in terms of years. For example:

> A cafeteria plan may operate on a plan year other than the calendar year for purposes of this transitional rule, so long as terms of the plan permit contributions to a plan to be fixed only once during, and a distribution of the unreimbursed amount to be received, only once for any plan year . . . .

Id. at A-21.

124. *Id.*

125. *See supra* note 68 and accompanying text (a cafeteria plan may not offer a benefit that defers the receipt of compensation).

elect the benefit at the appropriate intervals during the plan year (e.g., every four or six months, depending upon the plan's length).[126] Election of dependent care benefits would follow the same procedures and rules required when selecting other benefits from the "menu" at the beginning of the plan year.[127]

Dependent care benefits could also be automatically renewed in the subsequent dependent care plan period unless the employee requests modification. In the first plan's organization, employees would have to take some affirmative action to continue or modify their dependent care benefits. The advantage of the second plan is convenience for the employer and employee as well as reduced cost due to fewer administrative procedures.

These shorter plan periods would be subject to the same rules that apply to twelve-month plans. These rules, found in section 125 and the proposed regulations, dictate that the dependent care plan be established at the onset of the cafeteria plan year subject to the same risks and requirements as other benefits under a cafeteria plan. The only difference would be that at certain specified times during the year, and for a limited number of reasons,[128] dependent care would be subject to limited modification by the employee. In addition to having more opportunities during the year to make dependent care alterations, employees should be allowed to alter their benefit plans when certain other changes of circumstances occur.

2. *Changes of Circumstances; Changes in Benefits*

The currently proposed Treasury regulations allow revocations of changes in benefits to be made only if there is a change in family

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126. Rollovers and reimbursements would still not be allowable in either plan, although the risk of lost benefits is smaller due to the shorter plan length.

127. The procedure to be followed when choosing benefits would be those determining what election forms to fill out, to whom they are returned, and deadlines for electing the benefits. The total amount of dependent care benefits available for the year would be determined at this time and divided according to the length of the dependent care plan. For example, if the amount of dependent care benefits chosen by an employee were to be $2,000 for an entire cafeteria plan year, and there were two dependent care plans within that year, each of six-months duration, for each dependent care plan, the employee would be allowed $1,000. If, after four months and $800 worth of dependent care costs were incurred, the employee's need for dependent care ceased or was diminished, any remaining amount in the plan up to $200 would be forfeited. The $1,000 allocated to the second dependent care plan would not be available for any other benefits in the cafeteria plan, as they would have been irrevocably and unalterably chosen at the beginning of the cafeteria plan year. The remaining $1,000 would then be given to the employee as compensation and thus be includable in gross income.

128. *See infra* notes 130-32 and accompanying text (discussion of changes in circumstances that allow modification of dependent care plans).

status.[129] In the dependent care area, however, needs may change significantly due to illness, injury, or even new job opportunities. These are all fairly unpredictable events. This proposal allows a greater number of acceptable changes in circumstances for the purpose of changing benefit plans. The additional acceptable circumstances, set forth below, increase flexibility for employee benefit plans. Revenue collection is made more efficient also by increasing opportunities for employees to decrease, without penalty, their nontaxable benefits.

Changes in dependent care benefits should be allowed when a dependent[130] can no longer take care of herself, such as when an elderly parent suddenly becomes ill or injured.[131] Allowances should be made for children/dependents beginning school, or changing from half-day to full-time school.[132]

Changes should also be allowed when the spouse responsible for dependent care begins school or an occupation, becomes ill or injured, or is suddenly unable to provide adequate care for dependents. At times this may occur on an unexpected, temporary basis, such as when a dependent parent or caretaker is ill for a short period. This type of dependent care cannot be predicted a year in advance. Assuming dependent care which meets the statutory requirements[133] could be obtained on a temporary basis, cafeteria plan participants should have the opportunity to tailor their plan to meet their legitimate needs.[134] Allowable changes must be those stemming from need.[135] It is the responsibility of employers establishing the plans to see that abuse does not occur. This could be done by requiring documentation of changes in circumstances, such as hospital bills, insurance forms, or bills for the dependent care that was required. De-

129. Treas. Reg. § 1.125-1 (1984), 49 Fed. Reg. 19,322, at A-8 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984).

130. *See supra* note 107 and accompanying text ("dependent" as used in the IRC and in this comment is not limited to children of the taxpayer but includes all individuals listed in I.R.C. § 152 (1985)).

131. *See* Goldfarb & Campbell letter, *supra* note 86.

132. In the case of a dependent who is not a child, a distinction must be made between medical and nonmedical dependent care, as some medical forms of care, such as placement in a nursing home, may be covered by other benefits such as insurance. Dependent care as used in this comment is not intended to include any form of medical care.

133. *See* I.R.C. § 129 (1985).

134. *See supra* notes 103-04, 109-11 and accompanying text (discussion of acceptable dependent care assistance programs as defined in I.R.C. §§ 129, 21 (1985)).

135. Travel for pleasure, or attendance at a school or seminar which would not qualify for other fringe benefits under I.R.C. § 117 (1985) (scholarships and fellowships), would not constitute a legitimate situation under which a change would be required, and would not be thus covered.

pendent care bills could be sent to the employer for verification, allowing the employer the opportunity to keep accurate records of the costs incurred. Policing of these changes is necessary to prevent IRS dissatisfaction with the plans. IRS dissatisfaction could lead to more rigid regulations of cafeteria plans, thereby reducing the availability and effectiveness of dependent care benefits.

C. *Discrimination Standards and Proposed Rules*

The discrimination rules in the proposed regulations[136] require an examination of benefits chosen by employees regardless of how the benefits were offered. The result is that an established plan which does not intend to discriminate against a group of employees, may be judged discriminatory after all the benefits have been chosen. Discriminatory plans are invalidated.[137]

This proposal requires cafeteria plans to be evaluated on the basis of the *offered* benefits, and not those actually selected. Consider the following situation: A cafeteria plan offered in a small corporation may offer dependent care to all of its ten employees. The corporation's president and vice president, and one other officer are highly compensated within the meaning of section 125(c).[138] These three employees and one of the others choose the nontaxable dependent care option. The other six employees choose cash or other taxable benefits. Under the proposed Treasury regulations, this plan would be discriminatory even though every employee was entitled to the nontaxable dependent care benefits, because the benefits actually selected by the employees "discriminated" in favor of those highly compensated.[139] The changes herein proposed would judge whether or not a plan is discriminatory on the basis of *offered* benefits, not *selected* benefits. If the written cafeteria plan, presented and explained to employees,[140] allowed equal amounts of taxable and nontaxable benefits to all categories of employees, the plan would not be discriminatory. The written plan itself may not discriminate in favor

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136. Treas. Reg. § 1.125-1 (1984), 49 Fed. Reg. 19,322, at A-11 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984).

137. *Id.* at A-10.

138. *See supra* note 58 and accompanying text (definition of "highly compensated participant and individual").

139. *See* Treas. Reg. § 1.125-1 (1984), 49 Fed. Reg. 19,322 at A-19 (1984) (to be codified at 26 C.F.R. pt. 1) (proposed May 7, 1984) for rules governing whether a cafeteria plan is discriminatory.

140. *See supra* note 73 and accompanying text. Copies of letters and other posted information showing that employees were aware of the plan in detail could be required in the reporting and recording requirements.

of highly compensated employees, or officers, owners, or their dependents,[141] but discrimination should be based upon the plan that is offered, not the benefits chosen.[142]

This will serve the needs of employees by removing artificial barriers to obtaining dependent care. Offering a nondiscriminatory plan is within an employer's control. What benefits are actually chosen, however, is under no one's control.[143] A fair distribution of benefits, based solely upon need, will be achieved using the above proposed discrimination rule.

In addition to increasing the probability that an employee will be entitled to take advantage of dependent care benefits, this proposal decreases the chances of plan invalidation. Under this proposal plans would be invalidated only if they were discriminatory from their inception. Careful planning by the employer can virtually eliminate this invalidation. The employer could thus establish a plan which she knows will be valid. Under the currently proposed regulations, there is no guarantee that a carefully drawn plan will survive. Employers will not be willing to invest time, energy, and money into the development of a new benefits plan without a reasonable assurance that the plan will be accepted. This proposal offers such assurance by examining the employer's plan as it was intended. Without fear of invalidation, cafeteria plans become more attractive and are more likely to be established.

V. Conclusion

Cafeteria plans must be encouraged as part of the efforts to increase employer-provided dependent care. If flexible enough, they can efficiently accommodate the benefit needs of employees, yet allow maximum collection of revenue by the IRS.

The taxation of fringe benefits is an ambiguous area which has little cohesive underlying rationale. The lack of regulation, clarity, and precedent has led employers to establish liberal fringe benefit plans, including cafeteria plans. The IRS countered these liberal

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141. *See* I.R.C. § 129(d)(2) (1985).

142. Although a nondiscrimination test based upon benefits actually selected introduces uncertainty and additional administrative burdens into testing for discrimination, the basic test should not be difficult to pass because the need for the most expensive benefits, particularly medical benefits, generally does not increase proportionally with pay. Chip, *New Cafeteria Plan Regulations Contain Implications for Other Employee Plans*, 63 J. of Tax'n 72 (1985) at 74.

143. Employees must be allowed to base their selection of benefits on their individual needs without concern for the choices of other employees. Intricate inter-office balancing of benefits is not necessary to avoid discrimination, thus it should not be required.

plans with strict regulations which increase revenue, yet make cafeteria plans less practical for employees, particularly those in need of dependent care benefits.

The solution is to encourage the establishment of effective cafeteria plans. The guidelines proposed in this comment satisfy the revenue collecting policies of the IRS, and encourage employers to offer cafeteria plans which provide employees with a low-cost, convenient way to increase employer assistance for dependent care. The flexibility of these suggested changes eliminates the need for rollovers and reimbursements, the major catalysts of IRS opposition. Employers should be encouraged to provide dependent care, and cafeteria plans are one of the best means available.

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